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AUTHOR Hauptman, Arthur
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ABSTRACT

Federal costs of the National Direct Student Loan (NDSL) program and the Guaranteed Student Loan (GSL) program are compared, and alternatives to the current system of student financial assistance are discussed. It is estimated that over the life of the loan, the long-term federal costs of GSL and NDSL per dollar loaned are approximately the same under current policies. Both NDSL and GSL cost the federal government slightly less than 50 cents for every dollar loaned over the life of the loan assuming moderate future market interest rates. Four possible modifications to NDSL are addressed: raising the interest rate for borrowers, reducing the federal share of capital, requiring the use of private sector loan servicing agencies to reduce the incidence of default, and eliminating the existing loan cancellation provisions for certain kinds of teaching and military service. It is projected that these modifications would reduce federal costs for NDSL over the life of the loan by 17 cents per dollar loaned, or roughly 35 percent of the long-term federal costs at moderate levels of market interest rates. It is advocated that the sources of capital for students loans should be diversified to reduce the possible consequences of large-scale withdrawal from the GSL program. (SW)

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FEDERAL COSTS FOR STUDENT LOANS: IS THERE A ROLE FOR INSTITUTION-BASED LENDING?

Arthur Hauptman

June 1985

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American Council on Education
One Dupont Circle
Washington, D.C. 20036-1193

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FEDERAL COSTS FOR STUDENT LOANS:

IS THERE A ROLE FOR INSTITUTION-BASED LENDING?

Arthur Hauptman

June 1985

Funding for this report provided by the Exxon Education Foundation

Foreword

Since 1958 the National Defense (now Direct) Student Loan (NDSL) program has provided important support for low-income students. As Congress prepares to reauthorize the Higher Education Act of 1965, however, the continued existence of NDSL has been called into question and its future hangs in the balance.

In recent years Congress has been increasingly reluctant to fund NDSL, and its appropriations have been reduced as funding for the Guaranteed Student Loan program has grown enormously. While Congress has preserved the entitlement nature of GSL, its original purpose -- to provide loans of convenience -- has been restricted, so that it is now essentially need-based -- thus raising the question as to how two need-based loan programs can be justified.

As the Reagan Administration has sought to eliminate the NDSL program, increasingly serious attention has been given to suggestions for melding it into the GSL program, with NDSL revolving funds either returned to the U.S. Treasury or turned over to institutions to make additional loans or provide other forms of student assistance.

Therefore, to provide further background information for consideration of such options during the reauthorization process, ACE's Division of Governmental Relations requested a careful analysis of NDSL costs compared to those of GSL. In response, ACE's Division of Policy Analysis and Research commissioned this report as part of its effort to identify and assess new alternatives to the current system of student financial assistance.

This study by Arthur Hauptman, an educational consultant who has written on many student aid issues, provides a basis for considering changes which might make NDSL a desirable and less costly alternative to GSL.

Charles B. Saunders
Vice President for
Governmental Relations

INTRODUCTION AND SUMMARY

Of the two principal federal student loan programs -- Guaranteed Student Loans (GSL) and National Direct Student Loans (NDSL) -- GSL has grown rapidly over the past decade while NDSL has remained level or declined. Although NDSL is the older of the two programs, GSL for many years has been the larger one in terms of loan volume and federal expenditures. The annual loan volume in GSL now exceeds the amount of loans made in NDSL by a ratio of roughly 10 to 1. Annual federal expenditures for GSL are more than fifteen times larger than what the federal government annually spends for NDSL.

The difference in the relative size and growth of these two programs stems in part from the way each is treated in the federal budget. GSL is an entitlement program: no limit is placed on the amount of loans that a bank can make and the federal government is then legally obligated to make a series of payments over the life of the loan. Loan volume in NDSL, on the other hand, is limited by the amount of available funds. In addition, loan capital in GSL does not appear as a federal expenditure whereas most of the loan funds for NDSL initially come from direct federal appropriations. These two factors -- GSL's entitlement status and its "off-budget" financing of loan capital -- are critical reasons why over time GSL has become so much larger than NDSL.

The two programs operate in distinctly different ways, which makes it difficult to compare their relative costs to the federal government. In GSL, banks and other private lenders provide the loan capital. The federal government guarantees the loans against loss and makes a series of interest payments to lenders designed to keep the loans competitive with other investment opportunities. NDSL, on the other hand, is administered by educational institutions, not bankers, with the federal government providing the bulk of the initial loan capital. Unlike GSL, the federal government has a small financial commitment in NDSL once the loan is made, and repayments of old loans go into a revolving fund maintained by the educational institution for the purpose of making new loans.

In the first section of this report, the federal costs of GSL and NDSL are compared on the basis of how much each

program costs the government over the life of the loan. These long-term cost estimates yield a different result than looking at the annual costs of the two programs. Over the life of the loan, our estimates indicate that the long-term federal costs of GSL and NDSL per dollar loaned are approximately the same under current policies.

Both NDSL and GSL cost the federal government slightly less than 50 cents for every dollar loaned over the life of the loan assuming moderate future market interest rates (Treasury bill rates of 10%). These cost estimates, however, depend to some extent on the path of future interest rates. If interest rates rise substantially (with Treasury bills paying 13%), the long-term costs of NDSL and GSL increase to roughly 55 cents per dollar loaned. If future interest rates are low (Treasury bill rates of 7%), then federal costs could fall below 40 cents per dollar loaned. At all interest rate levels, the long-term federal costs of NDSL are slightly less than GSL. The table, below, summarizes these cost estimates.

DISCOUNTED FEDERAL COSTS OF GSL AND NDSL
OVER THE LIFE OF THE LOAN

Costs Per Dollar Loaned
If Future Market Interest Rates Are Assumed To Be:

	Low	Moderate	High
GSL	$.36	$.47	$.56
NDSL	$.35	$.45	$.53

One means for lowering the federal costs of student loans is to reduce the long-term costs of the NDSL or a similar institution-based loan program, and then rely on this type of loan more than is currently the case. Four possible modifications to NDSL are discussed in the second section of this report: raising the interest rate for borrowers, reducing the federal share of capital, requiring the use of private sector loan servicing agencies to reduce the incidence of default, and eliminating the existing loan cancellation provisions for certain kinds of teaching and military service.

As the following table indicates, each of these changes would help reduce the long-term costs of NDSL. Taken together,

we estimate that modifications discussed here would reduce federal costs for NDSL over the life of the loan by 17 cents per dollar loaned, or roughly 35 percent of the long-term federal costs at moderate levels of market interest rates. (The cost savings from the individual items do not add to the total cost savings because in some cases different proposals would affect the same cost features.)

OPTIONS FOR REDUCING FEDERAL COSTS IN THE NDSL PROGRAM

Cost-Saving Measure	Savings Per Dollar Loaned
Raising the Interest Rate Charged to Borrowers from 5 percent to 8 percent	minus 5 cents
Lowering the Federal Share of New Capital from 90 percent to 75 percent	minus 8 cents
Requiring Educational Institutions to Use Loan Servicing Agencies	minus 2 cents
Eliminating the Loan Cancellation Provisions for Teaching and Military Service	minus 3 cents
All Four Measures Combined	minus 17 cents

The modifications to NDSL discussed here might be implemented for more reasons than simply reducing the federal costs of the program. Conforming NDSL interest rates and loan terms with those of GSL and eliminating the loan cancellation features of NDSL would help to rationalize the entire student loan structure; students would face the same loan terms and conditions regardless of which type of loan they borrowed. Reducing the federal matching rate would increase the incentives for educational institutions to manage their revolving funds more efficiently since a greater amount of their own funds would be involved. Requiring loan servicing by outside agencies would help to reduce the default rate in NDSL by relieving educational institutions of a responsibility that they are not paid to do and that most are ill-equipped to handle.

Another way, of course, to reduce the federal costs of student loans is to modify the much larger GSL program. The

rapid growth in federal costs for GSL has stimulated a number of proposals in recent years to reduce the costs of that program. But GSL is likely to prove resistant to large-scale change and cost reductions for at least two reasons having to do with the structure of the program. First, 80 percent or more of annual federal costs for GSL are the result of loans made in previous years, thus making it difficult to achieve large short-term cost savings without debilitating the program.

Second, the growth of the GSL program has very much derived from the federal government providing lenders with a rate of return tied to market interest rates. If the program were decoupled from market interest rates in any significant way, a large number of banks and the other lenders would likely reduce their participation or withdraw entirely from the program. These two conditions suggest the difficulties entailed in achieving large amounts of GSL cost savings.

This report argues that the most realistic strategy for reducing the federal student loan costs may be to enact a series of changes in the NDSL program, and then increase the reliance on this type of approach for providing students with needed loan capital. Whereas GSL has been resistant to any large-scale cost cutting proposal, a situation that likely will continue, it is not difficult to see how a reasonable set of cost cutting changes could be accomplished in NDSL. With these modifications in place, NDSL should then reasonably merit receiving a larger share of the federal student loan dollar.

Such a strategy would not only reduce the overall long-term federal costs of student loans, it also would introduce a greater degree of competition than currently exists in the student loan structure. Students, their families, and educational institutions now rely directly on the banks for student loans. Is that bad? It can be, because in any investment situation a high degree of dependence on any one funding source may be unhealthy.

In the case of student loans, what would happen if banks and other lenders decided to reduce substantially their participation in GSL, either because other investment opportunities became more attractive or program changes made GSL a less profitable undertaking? Nobody should doubt that either of these conditions could arise. In such an event, access to needed student loan capital could be dangerously reduced.

It seems prudent, instead, to diversify the sources of capital for student loans to reduce the possible consequences of large-scale withdrawal from the GSL program. That is another reason why reducing the federal costs of NDSL and devoting more resources to that program would be a wise public policy.

ESTIMATING THE LONG-TERM FEDERAL COSTS OF GSL AND NDSL

Because the GSL and NDSL programs are financed in substantially different ways, one must be careful when trying to compare the costs of the two programs.

In GSL, the initial federal cost is relatively low because loan capital is provided by banks and other private lenders. Once the loan is made, however, the federal government is obligated to make a string of payments to the lender over the life of the loan. The government pays lenders the interest while the borrowers are in school and for a short grace period thereafter. There is also a federal "special allowance" payment that compensates lenders for the difference between market rates of interest and the rate which the borrower is charged. The federal government guarantees the loan against loss through a reinsurance arrangement with state guaranty agencies, and pays the state guaranty agencies an administrative allowance of one percent of the loan amount when the loan is made. The GSL origination fee, established in 1981, partially offsets these federal costs; borrowers receive 5 percent less than the face value of the loan and the difference, which lenders retain, reduces the amount of federal interest payments.

In NDSL, the initial federal cost is relatively high because the federal government provides 90 percent of the loan capital. The remaining 10 percent is provided by educational institutions through their own endowment or other funding sources. Educational institutions are permitted to retain a small portion of the federal funds they receive -- on a sliding scale of between 3 to 5 percent -- to cover at least a portion of their administrative expenses. But the federal costs during the life of the loan are minimal. These costs consist of mainly of federal payments to lenders for those borrowers whose loan repayments have been forgiven because they are employed in certain teaching fields or specified assignments in the armed forces. Loan repayments in NDSL are funneled into a revolving fund maintained by the educational institution for the express purpose of making new loans, in effect reducing the need for new federal capital contributions.

The following table summarizes the annual costs of GSL and NDSL for fiscal year 1984 and the loan volume supported by each program. As the table indicates, GSL is far larger both in terms of annual costs and the amount of loans provided. Annual federal expenditures in fiscal 1984 for GSL interest, default, and other costs were $3.1 billion compared to NDSL costs of less than $200 million, a ratio of more than 15 to 1.

GSL AND NDSL ANNUAL FEDERAL COSTS AND LOAN VOLUME, FISCAL YEAR 1984

Guaranteed Student Loans

Annual Federal Costs: $3,131 million

In School Interest	$1,268 million
Special Allowance	$1,357 million
Default	$798 million
Other	$86 million
Origination Fee	($380 million)

Loan Volume $7.2 billion

National Direct Student Loans

Annual Federal Costs: $192 million

Federal Capital Contributions	$169 million
Cancellation Payments	$23 million

Loan Volume $763 million

Source: U.S. Department of Education

In terms of loan volume, GSL in fiscal 1984 provided loans totalling $7.2 billion, compared to the less than $800 million that NDSL provided through new capital contributions, institutional matching funds, and the use of repayments of existing loans into the revolving fund. Thus, at current levels, GSL provides roughly ten times as much in loans as NDSL.

Examining the current annual costs and loan volume of GSL and NDSL, however, does not provide a clear picture of what these programs cost over the life of the loan. Since GSL and NDSL have different patterns of expenditures over time, an analytic procedure that compares the long-term costs of the two programs should take into account when the dollars are spent. Such a procedure should recognize that a dollar today is worth more than a dollar in the future because the dollar today can be invested and thus add to its value. Present-value discounting of dollars, which meets the criteria listed above, is the procedure that has been used in this report for estimating the federal costs of GSL and NDSL over the life of the loan.

The following table provides estimates of the long-term federal costs of GSL and NDSL over the life of the loan under current policies. In order to provide a reasonable basis for comparison, 90 percent of the loan repayments in NDSL are considered to be an offset to federal costs since these funds will be used to make new loans. Under this approach, these loan repayments are being viewed as reducing the need for new federal capital contributions in the future. This is consistent with the intention of the program's sponsors who believed that eventually the revolving funds would be sufficient to fund the entire volume of loan capital, thus eliminating the need for new federal capital contributions.

The future path of interest rates will influence both the amount of federal special allowance payments in GSL and the rate at which future dollars are discounted. For these reasons, these long-term cost estimates are presented using three different projections of interest rates: a low future pattern of interest where the rate on Treasury bills is assumed to be 7 percent, a more moderate estimate of 10 percent, and a high path where Treasury bill rates are projected to be 13 percent.

FEDERAL COSTS OF GSL AND NDSL OVER THE LIFE OF THE LOAN UNDER CURRENT POLICIES*

	Federal Costs Per Dollar Loaned		
	Interest Rate Assumptions:		
	Low	Medium	High
Guaranteed Student Loans			
In School Interest	.21	.20	.19
Special Allowance	.13	.26	.36
Default Payments	.06	.05	.05
Admin. Cost Allowance	.01	.01	.01
Origination Fee	(.05)	(.05)	(.05)
GSL Total Costs	.36	.47	.56
National Direct Student Loans			
Federal Capital Contribution	.90	.90	.90
Loan Cancellation Payments	.03	.03	.02
Administrative Allowance	.04	.04	.04
Borrower Repayments	(.62)	(.52)	(.43)
NDSL Total Costs	.35	.45	.53

*These cost estimates project that borrowers will stay in school for an average of three years and that repayment will last an average of seven years. The cumulative default rate over the life of the loan is estimated to be 8 percent in the GSL program and 12 percent in NDSL. To simplify the calculations, in each program we have assumed that one-half of the defaults occur in the first year of repayment, one-quarter in the second-year of repayment, and the remaining one-quarter is assumed to occur in the third year. NDSL loan cancellations for teaching and other public service activities are estimated to be 3 percent of the loans in repayment, and the administrative allowance in NDSL is estimated to be 4 percent of the federal capital contribution.

As the table shows, the long-term federal costs of NDSL and GSL are very similar at all levels of projected interest rates. Both cost less than 40 cents per dollar loaned if market interest rates are low, almost 50 cents per dollar loaned when interest rates are moderate, and roughly 55 cents per dollar loaned if interest rates climb. GSL is slightly more expensive than NDSL at each of the three projected levels of interest rates.

As market interest rates increase, the cost of the GSL special allowance payments rise and thus the cost of GSL increases relative to NDSL, where no special allowance structure exists. On the other hand, increasing market interest rates also lead to a higher rate of discount for present value. To the extent that federal expenditures for GSL occur more in future years than do those for NDSL, the higher the interest rate the less the relative cost of GSL. On balance, it appears that the increase in special allowance payments has more impact than the additional discounting of future dollars that occurs as interest rates increase.

The preceding table also demonstrates the impact of interest rates on the composition of costs, especially in the GSL program. Special allowance payments are roughly one-third of GSL long-term costs when market interest rates are low, and substantially more than half of costs when interest rates are high. This underscores the central position of the special allowance formula in determining the long-term costs of the GSL program.

MODIFYING THE NDSL PROGRAM

The preceding section examined the long-term costs of GSL and NDSL as these programs presently exist. This section will examine what would happen to the costs of the NDSL program if it were changed. Why are we focusing on possible changes in the NDSL program when GSL is the much larger program?

There has been considerable discussion in recent years about how GSL program rules might be revised in order to reduce federal costs. The focus on GSL as a budget-cutting target derives from its rapid growth, its substantial size, and its status as an entitlement program. The changes that have been suggested have been wide ranging and have included raising the interest rate charged to borrowers, requiring a needs test for all borrowers, reducing the yield received by lenders, and curtailing the use of tax-exempt bonds for financing these loans.

In general, however, the GSL program has been resistant to any legislative change that would substantially reduce the federal costs of the program. Aside from the political popularity of GSL, the resistance to change lies largely in the nature of the program itself. First, most of the costs in any one year are a result of loans made in previous years and legally cannot be altered. Thus, even a major change in the terms of new loans would result in a relatively small change in near-term annual costs.

In addition, private sector lenders in the GSL program have insisted that their rate of return for student loans be consistent with their alternative investment opportunities. This relationship has been achieved through the federal special allowance payments that currently assure lenders of a rate of return 3.5 percentage points above the rate paid for 91-day Treasury bills. It appears likely that any substantial change in this formula could lead to a large-scale withdrawal of lenders from the program, with the result that access to loan capital would be severely curtailed.

Less discussed in recent years has been the possibility of altering the NDSL program to make it a less costly alternative to GSL, and thereby introduce an element of competition into the student loan structure that has not existed before. If

NDSL were made substantially less costly to the federal government than GSL, policymakers might be persuaded to direct more funds toward NDSL in an effort to reduce the overall federal costs of student loans.

This section discusses four possible modifications to NDSL, each of which would reduce the federal costs of the program in a meaningful way. One change would be to increase the interest rate charged to borrowers. Another would be to increase the share of initial loan capital provided by the educational institutions. A third possible change would require educational institutions to turn over their loan paper to outside agencies for loan servicing, in the hope that such a requirement would help reduce the incidence of default in NDSL. The final change discussed here is the elimination of existing loan cancellation provisions for certain types of teaching or armed forces assignments.

Raising the Interest Rate Charged to Borrowers

When the NDSL program was created in 1958, the interest rate charged to borrowers was set at 3 percent. Interest rates for Treasury bills at that time were roughly 2 to 3 percent, and so 3 percent seemed a reasonable rate to charge student borrowers. Since then, of course, the general level of interest rates has grown tremendously but interest rates in NDSL have hardly kept pace. In recent years, the NDSL interest rate has been increased on two occasions so that it is now 5 percent, still far below market rates and the rate charged in GSL.

An obvious cost cutting modification to the NDSL program would be to increase the interest rate charged to borrowers. One option in this regard is to increase the NDSL rate to what is charged to GSL borrowers, currently 8 percent for new borrowers. Raising the NDSL interest rate to that of GSL would reduce the long-term federal costs of NDSL by 5 cents per dollar loaned, an 11 percent reduction in the costs of the program at moderate market interest rates.

Bringing NDSL interest rates and terms into conformity with those of GSL would also have the salutary effect of rationalizing the overall structure of student loans. Students would be charged the same interest rate regardless of which type of loan they borrowed. Moreover, NDSL loans might become more compatible with the growing secondary market for student loans, thereby increasing the potential liquidity of NDSL loan paper.

It is also possible that interest rates charged to borrowers in the GSL program might be modified to reflect more closely market-based rates of interest. For example, the Administration in its Fiscal 1986 budget recommended charging GSL borrowers the Treasury bill rate. We estimate that if this proposal were adopted, the long-term federal costs of GSL would be reduced by 4 cents per dollar loaned at moderate levels of market interest rates (representing a 9 percent reduction in long-term costs) and by 9 cents per dollar loaned if Treasury bill rates increase to high levels (a 16 percent cost reduction).

Such a change could also be applied to the NDSL program if a policy to equalize GSL and NDSL interest rates were adopted. Compared to current policy of 5 percent NDSL interest rates, increasing the interest rate charged to NDSL borrowers to the Treasury bill rate would reduce federal costs for NDSL by 9 cents per dollar loaned at moderate interest rate levels (a 20 percent reduction in long-term costs). If future market interest rates are at high levels, the savings would be 12 cents per dollar loaned, a 27 percent reduction in the long-term costs of the program.

Lowering the Federal Matching Rate for New Loan Capital

The initial NDSL legislation set the federal matching rate at 90 percent. The expectation was that eventually repayments from old loans would be sufficient to sustain fully the volume of new loans with no further federal capital contributions needed. But the demand for new loans has far outstripped the volume made available through additional capital contributions and repayments into the institutional revolving funds.

One obvious way to stretch the use of federal dollars is to require that the educational institutions provide a larger share of the initial loan capital. We estimate that lowering the federal matching rate to 75 percent, for example, would reduce federal long-term costs by 8 cents per dollar loaned, a reduction of 18 percent in long-term costs under current policies assuming moderate interest rate levels.

Many educational institutions are presently implementing or developing plans to use their own funds as leverage to ensure sufficient capital availability for their students and families. These schools could certainly afford to increase their share of matching in the NDSL program, and thereby increase the overall amount of NDSL loans made. For other schools that are financially strapped, however, increasing the NDSL matching share

might not be viable. For these schools, either expansion through NDSL might not be a possibility, or they might be exempted from the higher matching requirements (with the consequence of reduced cost savings for the federal government).

It is also possible that nontraditional funding sources might be utilized to expand the amount of capital available through an institution-based federal student loan program. For example, many educational institutions now seem prepared to use their access to tax-exempt bonds as a means for financing alternative loan programs to combat the effects of possible cutbacks in the GSL program. With legislative modification, these funds could be used to provide the institutional share of matching funds in NDSL. One caveat is in order here: These nontraditional procedures could be more or less costly to the federal government than the current system depending on how the alternative financing was structured.

There is also a NDSL provision already on the books that would allow the federal government to use debt financing to supply capital to the NDSL program. Utilization of this financing mechanism might expand the amount of federal capital contributions relative to the current use of direct appropriations. Use of federal borrowing rather than direct appropriations to provide loan capital would reduce the initial federal budgetary cost of the NDSL program; the budget would show only the interest and principal repayments on the amount borrowed by the federal government. The long-term cost of federal borrowing, however, is identical to what it costs the federal government to provide loan capital through direct appropriations. The discounted value of interest and repayment of principal equals the initial amount borrowed.

Requiring the Use of Outside Loan Servicers

The high incidence of default in NDSL, and student loans generally, undermines confidence and serves as a major obstacle to expansion in funding for student loans. In the case of NDSL, there are several reasons why the current system results in an unacceptably high incidence of default. One reason is that the educational institutions are not paid to service loans, unlike the GSL program where a portion of the special allowance payment implicitly is provided to cover the costs of servicing. It is unrealistic on the government's part to expect educational institutions to perform what by all accounts is a difficult and costly task for no compensation.

Another contributing factor to the poor NDSL default track record has already been alluded to in the previous discussion of the federal matching rate. When educational institutions are asked to contribute a relatively small share of the loan capital, their incentive for servicing these loans is reduced. Along this line of reasoning, if the institutional share of capital were increased, institutions likely would exert additional effort in servicing the loans since more of their own money was involved.

It is also true that many educational institutions are simply not cut out to be loan servicers. Their main product is education, not loan collection, and most seem ill-equipped to handle the role of loan servicing. Even many of those educational institutions that do a reasonable job at loan servicing may not measure up to private sector standards. This track record has led the federal government in recent years to encourage many schools to turn over their bad loan paper to the federal government, which in turn allows private loan servicers to pursue the delinquent borrowers.

A more direct way of dealing with the NDSL default problem might be to require that educational institutions regularly utilize private loan servicers. If such a requirement reduced NDSL default rates to levels in the GSL program, the long-term federal costs of NDSL would be reduced by 3 cents per dollar loaned (a 7 percent reduction in long-term costs under current policies assuming moderate interest rate projections).

One particular of such a requirement should be to pay loan servicers per loan or per borrower, not on the basis of dollars borrowed as is currently done in the GSL program. The costs of loan servicing do not vary appreciably by the amount borrowed, and it seems more reasonable to pay for servicing on the basis of the number of borrowers who must be contacted and tracked.

Educational institutions with good track records in loan servicing might be allowed to maintain that function, if they so desire. For example, schools with default rates that seem comparable or better than private sector experience should probably be permitted to continue servicing the loans of their students and to retain whatever administrative fees are allocated for this purpose.

We estimate that the cost of loan servicing is approximately $100 to $150 per loan. This estimate is based on the notion that loan servicing appears to cost between 1 to 2 percent of

the amount loaned in the GSL program. This percent, when applied to the average loan amount and discounted for present value, results in our estimate of loan servicing costs per loan made.

A requirement to use private loan servicers could be financed in one of several ways. Educational institutions could be allowed to use a portion of their annual administrative allocation or the revolving fund to pay outside servicing fees. Or it might be in the federal government's financial interest to make a separate payment to educational institutions for the purpose of hiring outside servicing agencies. Finally, borrowers could be required to pay an insurance premium in the NDSL program, as they now do in the GSL program, for the purpose of reducing the incidence and the costs of default, which might reasonably include paying for the use of outside servicing agencies.

Eliminating the Loan Cancellation Provisions

When NDSL was first authorized, provision was made to forgive the loan repayment obligations of borrowers who became teachers. This provision remained in effect until the 1972 amendments to the legislation when it had become clear that an oversupply of teachers existed. At that time, the blanket provision of loan forgiveness for teaching was removed, and in its place, a more limited set of loan forgiveness provisions was enacted. Currently, loan forgiveness in NDSL is provided for borrowers who become teachers in low-income areas, who teach handicapped students, who serve in the Peace Corps or VISTA, and who are serving in certain types of hazardous assignments in the Armed Forces.

Although the goals are laudable, it does not appear that the existing provisions have had an appreciable effect on convincing individuals to go into the targeted types of service. The principal reason for this apparent lack of effectiveness probably lies in the fact that the amount of money involved in the cancellation of loan repayments is not sufficient to overcome the financial incentives for going into nondesignated fields.

The loan forgiveness provisions currently cost slightly more than $20 million annually in federal payments to replenish the revolving funds, roughly 3 percent of the current annual loan volume in the NDSL program. If these provisions were eliminated, the long-term federal costs of NDSL would be reduced by 3 cents per dollar loaned, or a 7 percent reduction in long-term federal costs at moderate market rates of interest.

Taken together, the four modifications discussed in this section would reduce the long-term federal costs of NDSL by an estimated 17 cents per dollar loaned. As in the case of any estimates, the actual savings achieved by these modifications would vary from the estimates provided here depending on the exact nature of the changes made and the accuracy of the assumptions used in making the estimates. But we believe these estimates provide a realistic assessment of the approximate impact on costs that might be achieved through adoption of the modifications that have been discussed in this report.